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In the

Supreme Court of the United States

October Term, 1975

No. 75-1374

CAM F. DOWELL, JR., EVELYN DOWELL
&
HILLCREST STATE BANK,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATED COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioners Cam F. Dowell, Jr., Evelyn Dowell, and Hillcrest State Bank respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered in the proceeding on November 7, 1975, and the order denying the Petition for Rehearing entered on December 29, 1975.

OPINIONS BELOW

The opinion of the Court of Appeals, reported at 522 F. 2d 708 (5th Cir. 1975), appears in Appendix I hereto; the Judgment of the Fifth Circuit appears in Appendix II hereto; and the order of the Fifth Circuit denying the Petition for Rehearing appears in Appendix III hereto. The opinion of the United States District Court for the Northern District of Texas, Dallas Division is reported at 370 F. Supp. 69, and appears in Appendix IV hereto.

JURISDICTION

The Court of Appeals for the Fifth Circuit denied Petitioners' Petition for Rehearing on December 29, 1975, and this petition for certiorari is filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254 (1).

QUESTION PRESENTED

Whether the decision of the Court of Appeals for the Fifth Circuit is in conflict with both the Second Circuit in *La Forge v. Commissioner of Internal Revenue* and the Internal Revenue Code and the Regulations thereunder in connection with the degree of substantiation required to meet the requirements of Section 274 of the Internal Revenue Code of 1954 for business travel expenses, expenses for business meals and for gifts; whether the evidence presented by the taxpayers of amount, time and place, business purpose and business relationship is sufficient as to both that section of the Internal Revenue Code of 1954 and the Regulations thereunder.

STATUTORY PROVISIONS INVOLVED

INTERNAL REVENUE CODE of 1954, as amended, United States Code, Title 26, Section 274, provides in relevant part as follows:

> "(d) SUBSTANTIATION REQUIRED – No Deduction shall be allowed –
>
> (1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),
>
> (2) for any item with respect to any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, or
>
> (3) for any expense for gifts,
>
> unless the taxpayer substantiates by adequate records *or by sufficient evidence corroborating his own statement* (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift. The Secretary or his delegate may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations." (Emphasis added.)

TREASURY REGULATIONS, 26 C.F.R. Section 1.274-5(b)(3)(v) state that business relationship need not be shown by specific name of the individual, but may be established by:

> "Occupation or other information relating to the person or persons entertained, including name, title, or other designation, sufficient to establish business relationship to the taxpayer".

Section 1.274-5(c) provides in part:

> "(c) Rules for substantiation – (1) In general. *A taxpayer must substantiate each element of an expenditure (described in paragraph (b) of this section) by adequate records or by sufficient evidence corroborating his own statement except as otherwise provided in this section.* Section 274(d) contemplates that a taxpayer will maintain and produce such substantiation as will constitute clear proof of an expenditure for travel, entertainment, or gifts referred to in section 274. A record of the elements of an expenditure made at or near the time of the expenditure, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall. *Thus, the corroborative evidence required to support a statement not made at or near the time of the expenditure must have a high degree of probative value to elevate such statement and evidence to the level of credibility reflected by a record made at or near the time of the expenditure supported by sufficient documentary evidence.* The substantiation requirements of section 274(d) are designed to encourage

taxpayers to maintain the records, together with documentary evidence, as provided in subparagraph (2) of this paragraph. To obtain a deduction for an expenditure for travel, entertainment, or gifts, a taxpayer must substantiate, in accordance with the provisions of this paragraph each element of such an expenditure. . . .

(3) Substantiation by other sufficient evidence. If a taxpayer fails to establish to the satisfaction of the district director that he has substantially complied with the 'adequate records' requirements of subparagraph (2) of this paragraph with respect to an element of an expenditure, then, except as otherwise provided in this paragraph, the taxpayer must establish such element –

(i) *By his own statement, whether written or oral, containing specific information in detail as to such element; and*

(ii) *By other corroborative evidence sufficient to establish such element.*

If such element is the description of a gift, or the cost, time, place, or date of an expenditure, the corroborative evidence shall be direct evidence, such as a statement in writing or the oral testimony of persons entertained or other witness setting forth detailed information about such element, or the documentary evidence described in subparagraph (2) of this paragraph. *If such element is either the business relationship to the taxpayer of persons entertained or the business purpose of an expenditure, the corroborative evidence may be circumstantial evidence.*" (Emphasis added.)

STATEMENT OF THE CASE

This is a tax refund case involving four suits for refund commenced for the recovery of income taxes and interest paid under protest by the Hillcrest State Bank (hereinafter sometimes referred to as "Hillcrest") and by Cam F. Dowell, Jr., and his wife, Evelyn Dowell (hereinafter sometimes referred to as "Dowell") (hereinafter collectively referred to as "taxpayers."). The four suits involved the years 1964 through 1967, and the

original amounts of taxes in issue were $21,665.15 for Hillcrest and $31,861.44 for Dowell. As the result of stipulations, the taxes in issue are presently $16,967.37 for Hillcrest and $28,081.04 for Dowell.

Hillcrest is a state bank, incorporated in the State of Texas, located in University Park, a suburban city some distance from the business center of Dalias, Texas. Dowell was President and Chief Executive Officer of Hillcrest during all of the years in question. Dowell also had business interests in Greenville, Texas, which is about 54 miles from Dallas.

The taxes in issue resulted from the disallowance by the Internal Revenue Service of substantially all of the taxpayers' claimed deductions for the cost of Dowell's travel and his meals with customers, prospective customers, directors, prospective directors, governmental banking officials and many other persons directly related to the business of Hillcrest. The expenditures in issue relative to Hillcrest are virtually all expenses incurred for 1964, 1965 and 1966; only a little over four months of 1967 was disallowed and the balance was allowed by the Internal Revenue Service. The expenditures in issue relative to Dowell's Greenville business pertain only to 1965, 1966 and 1967; virtually the same expenses were allowed by the Internal Revenue Service for 1964.

Claims for refund were timely filed and the suits for refund were properly commenced. The four suits were consolidated for trial and tried before the District Court on August 15 and 16, 1972.

At the trial, taxpayers presented evidence in the form of bills from restaurants, clubs, travel agencies, hotels and airlines which specifically established that the actual sums in issue were spent, where they were spent, and, with de minimus exceptions, the exact date of the expenditure. These exceptions, which were greatly overemphasized by the Fifth Circuit, were the statements of American Express and the Texas Club. Those statements all showed the amount spent but constituted a monthly aggregate and did not show the exact day of the expenditure but only the month. The American Express and the Texas Club constituted less than six percent of the total amounts denied by the revenue agent. Dowell testified that the majority of the expenses were incurred for business meals with customers,

prospective customers, shareholders, directors, prospective directors, governmental banking officials and specific other persons directly related to the business of Hillcrest.

There was substantial testimony from twenty-three witnesses in addition to Dowell, who were customers, officials of other banks, members of Hillcrest's Board of Directors, banking officials, employees of Hillcrest, club waiters and business associates. Eight directors of Hillcrest during the years in issue testified that they themselves had been entertained, that Dowell was the primary force in the growth and existence of Hillcrest, and that Dowell's travel and entertainment were not only approved by the directors, but were mandatory to the successful operation of Hillcrest. One of the directors categorically stated that if Dowell had not entertained and traveled, "he would be derelict in his duty". Five employees of Hillcrest testified that Dowell took customers, directors and important contacts to lunch four to five times weekly in each week in each year in issue. Two executives of two other large Dallas, Texas, banks testified that the type of expenditures in issue are ordinary, necessary and typical in the successful operation of a bank. Two club managers and a head waiter testified that the clubs in issue were conducive to and were utilized by Dowell for quiet, dignified business meetings.

The District Court found that the deductions claimed were for ordinary and necessary business expenses and the taxpayers sufficiently substantiated the same. Judgments were entered in favor of Hillcrest and Dowell. The Fifth Circuit reversed, holding that the taxpayers provided sufficient evidence to establish the requisites of Section 162 of the Internal Revenue Code and that the expenses were ordinary and necessary; that the taxpayers provided sufficient circumstantial evidence to establish the requirement of Section 274(d) of the Internal Revenue Code that there was a business purpose for the entertainment; but the Fifth Circuit goes on to hold, contra to the Second Circuit decision in *La Forge v. Commissioner of Internal Revenue* and the language of the Treasury Regulations that circumstantial evidence will not suffice to establish business relationship. The Fifth Circuit also greatly overemphasized the de minimus Texas Club and American Express chits – which were only six percent of the total expenses – in attacking taxpayers' literal blizzard

of other evidence and the very meticulous detailed opinion of the Trial Court whose factual findings should rarely be overturned by an appellate court.

REASONS FOR GRANTING THE WRIT

1. The decision of the Fifth Circuit conflicts in principle with the decision of the Second Circuit *in LaForge v. Commissioner of Internal Revenue*

Taxpayers assert that the Fifth Circuit misapprehended the law and distorted the facts submitted to the Trial Court by taxpayers as the Fifth Circuit attempted to distinguish the facts, the opinion and the holding of the Second Circuit in the case of *LaForge v. Commissioner of Internal Revenue*, 434 F. 2d 370 (2nd Cir. 1970) and two of its successor cases from the facts of this case. Taxpayers specifically call this Court's attention to the fact that in the *LaForge* opinion, the Second Circuit states that Laforge identified the individuals he entertained as "the residents and interns who assisted me" 434 F. 2d at 371. This designation is no more specific than the designation of "customers, prospective customers, directors or prospective directors" as identified by taxpayers and found as facts by the District Court.

The substantiation presented by Dr. LaForge is much less specific than that presented by taxpayers, as there was no specific designation of the amount spent. Dr. LaForge utilized the testimony of the cashier of the hospital cafeteria as his sole corroborative evidence to establish the fact that he spent between $2.65 and $3.00 on lunches each day for every day that he was scheduled at the hospital. Dr. LaForge goes on to claim deductions of $2.00 for each of these days for business lunches. Taxpayers presented specific evidence as to the exact amount spent for each of the items claimed to be deductible as business entertainment expenses. The Fifth Circuit further attempts to distinguish the *LaForge* decision from the case at hand on the basis that:

> "The amounts in LaForge *were much smaller*. All of the claimed expenses were in the same category, and LaForge presented corroborative evidence in his own statement concerning the amounts, dates and business relationship with respect to each expenditure. The entertainees were

> all from a small, identifiable group, and the business relationship to the taxpayer was clear." (522 F. 2d f/n 10 at page 715). (Emphasis added.)

The amount of the expenditures are totally irrelevant and no consideration is given by any authorities to require lesser substantiation or fewer opportunities for abuse. Taxpayers' evidence is a much higher degree of evidence than that presented by Dr. LaForge as taxpayers presented documentary evidence as to time and amount whereas LaForge had none of the same. The *LaForge* Court allowed approximation of expenses which does not exist in the present case. The Fifth Circuit further attempts to distinguish the facts of this case from those of *Hughes v. Commissioner of Internal Revenue*, 451 F. 2d 975 (2nd Cir. 1971) and *Handelman v. Commissioner of Internal Revenue*, 509 F. 2d 1067 (2nd Cir. 1975). In *Hughes* the taxpayer had no receipts or statements and presented no corroborative evidence; he relied only upon his own testimony. In the instant case all expenses have been itemized and documentary evidence presented. In *Handelman* the Court dealt with a situation of total abuse, the taxpayer had a gross income of over $520,000 during the three years in issue; however, his total net income was a minus $10,000. The income of the Hillcrest Bank increased every year in issue. The facts of this case do not in any way resemble either *Hughes* or *Handelman*.

In view of the immediate impact of the Fifth Circuit's decision on the substantiation requirements of Section 274 of the Internal Revenue Code upon the taxpayers of that Circuit as well as the unfairness of a different standard being applied to Second Circuit taxpayers similarly situated, taxpayers respectfully submit that this conflict justifies the grant of certiorari to review the judgment below.

2. The Fifth Circuit's decision raises important and recurring problems in judicial and administrative application of Section 274 of the Internal Revenue Code of 1954

The Fifth Circuit misapprehended the law and the Congressional intent in Sections 162 and 274(d) of the Internal Revenue Code of 1954 in its implied holding that the designation of

"customer, prospective customer, director or prospective director" will not satisfy the requisites to substantiate "business relationship" pursuant to Section 274(d)(3)(D). The Fifth Circuit ruled that taxpayers not only presented sufficient evidence to satisfy the requirements of Section 162 but also that the record establishes the business purpose of the expenditures. The record clearly establishes that the actual sums in issue were spent, where they were spent, and when they were incurred, with de minimus exceptions. The Fifth Circuit discussed at length both the Texas Club and American Express. The record contains the testimony of William McKinley who was the headwaiter of the Texas Club during the years in issue. Mr. McKinley testified that he personally observed Dowell partaking in business-type luncheons during the years in issue. Despite the emphasis by the Court on the monthly aggregates by the billings of American Express and the Texas Club, the total amount spent on business entertainment relating to these two billings during the years in issue represents less than six percent of the total amounts of deductions denied by the revenue agent. The prevention of abuse is the purpose of Sections 162 and 274. The abuse aimed at by Congress was the ability of taxpayers to estimate their business entertainment expenditure under prior law. There is no estimation of the amount of any expenditure in the present case as taxpayers have presented documentary evidence of the exact amount of each expenditure in issue.

As the Fifth Circuit accurately stated, Section 274(d)(3) requires that "the business relationship to the taxpayer of the persons entertained must be substantiated by "adequate records or by sufficient evidence corroborating his own statement." Section 1-274-5(b)(3)(v) of the Treasury Regulations provides that business relationship may be proved by showing:

> "Occupation or other information relating to the person or persons entertained, including name, title or other designation, sufficient to establish business relationship to the taxpayer."

This disjunctive "or" is stated in the Regulation and taxpayers presented evidence that customers, prospective customers, shareholders, directors, prospective directors, governmental banking officials and specific other persons directly related to

the business of Hillcrest were entertained. The phrase "specific designation" as stated on page 716 of the Fifth Circuit's opinion ("and the business relationship cannot be ascertained unless the taxpayer establishes the identity of his entertainee – whether by name, title, or other specific designation" 522 F. 2d at 716) is no place to be found, and is a misuse, misconstruction and illegal addition to the Regulations which requires "other designation".

Taxpayers assert that this Court should especially consider the above cited and emphasized portions of the Treasury Regs. 1-274-5(c)(3) which state the guidelines for establishing the ilements of Section 274(d). These guidelines specifically allow circumstantial evidence as the corroborative evidence to establish business relationship or business purpose. The Committee reports pertaining to Section 274 provide that:

> ". . . the degree of corroboration required to support a claimed deduction will vary as respects the business relationship and purpose, the time and place, and the amount of the expense. Thus, oral testimony of the taxpayer together with circumstantial evidence available, may be considered 'sufficient evidence' for the purpose of establishing the business purpose required under the new provision. However, oral testimony of the taxpayer plus more specific evidence would be required to be 'sufficient evidence' as to the amount of an expense." (S. Rep. No. 1881, 87th Cong., 2d Sess. (1962) in 1962-2 U.S. Code & Cong. Admins. News. pp. 3337-38.)

Thus, both the Regulations and the legislative history require a higher degree of corroboration, "direct" or "specific" evidence, as to the elements of time, amount and expense – all of which elements taxpayers proved and the Fifth Circuit concurs. But circumstantial evidence satisfies the elements of business purpose and business relationship, which were also proved.

The taxpayers presented direct evidence of the elements of cost, time, and place of the expenditures of the items in issue and the District Court held that the taxpayers met the burden of furnishing circumstantial evidence as to business relationship to corroborate the written evidence and Dowell's oral testimony. The Fifth Circuit was satisfied as to the business purpose.

Black's Law Dictionary defines circumstantial evidence to include "all evidence of indirect nature." It goes on to state that it is:

> "The proof of various facts or circumstances which usually attend the main fact in dispute, and therefore tend to prove its existence, or to sustain, by their consistency, the hypothesis claimed. Or as otherwise defined, it consists in reasoning from facts which are known or proved to establish such as are conjectured to exist."

The Sixth Circuit considered the concept of circumstanital evidence and stated that:

> "Since the intent with which an act is done is rarely if ever susceptible of proof by direct evidence, it must be ascertained from outward manifestations – from words or acts of a party in accomplishing the act and from the facts and circumstances attendant upon the act." [*United States v. H. M. Branson Distributing Company,* 398 F. 2d 929, 943 (6th Cir. 1968)]

The term has also been defined as "evidence which, without going directly to prove the existence of a fact, gives rise to a logical inference that such fact does exist." [*United Textile Workers v. Newberry Mills, Inc.*, 238 F. Supp. 366, 373 (W. D. S. C. 1965)].

Taxpayers presented evidence that bankers are required to entertain; that Dowell was required to entertain by the directors of the Hillcrest Bank and the testimony of numerous people who had been entertained; that if Dowell had not entertained and traveled, "he would be derelict in his duty"; that Dowell took customers, directors and important contacts to lunch four to five times weekly during the years in issue; and that the deposits and profits increased tremendously during the years in issue.

The Fifth Circuit found that Dowell "was a creature – or captive – of the business world, thereby establishing business purpose." (522 F. 2d at 714), as the result of his daily and continuous business dealings over lunch. Thus, the Fifth Circuit accepted and approved the corroborative circumstantial evidence presented by taxpayers.

Taxpayers assert that based upon the prerequisites of the Internal Revenue Code, the Commissioner's own Regulations, the Congressional intent, and the elements herein found to have been established by taxpayers that the designation of "customer, prospective customer, director or prospective director" satisfies the business relationship requirement of Section 274(d)(3), this Court should grant certiorari to review the judgment below.

The Fifth Circuit has attempted to find abuse and failed; it misinterpreted and misappied the Internal Revenue Code and the Commissioner's Regulations. In so holding, the Fifth Circuit has adopted a standard that deviates from the clear congressional intent in the adoption of Section 274 and has held directly contra to the Second Circuit in *LaForge*.

CONCLUSION

For the reasons stated above, a writ of certiorari should issue to review the judgment, opinion and the order denying the Petition for Rehearing of the Fifth Circuit.

Respectfully submitted,

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Cam F. DOWELL, Jr., Evelyn Dowell and Hillcrest State Bank, Plaintiffs-Appellees,

v.

UNITED STATES of America, Defendant-Appellant.

No. 74-3057.

United States Court of Appeals, Fifth Circuit.

Nov. 7, 1975.

The United States appealed from a judgment of the United States District Court for the Northern District of Texas, at Dallas, 370 F.Supp. 69, William M. Taylor, Jr., Chief Judge, allowing recovery to a bank and the chairman of its board in income tax refund suits arising out of the Internal Revenue Service's disallowance of certain business expense deductions. The Court of Appeals, Brown, Chief Judge, held that the trial court erred in finding that a "blizzard" of bills, chits, etc., established the amounts, dates and places of the claimed expenditures rather than requiring that the taxpayers substantiate each such expenditure with the specificity required by statute.

Vacated and remanded.

Internal Revenue ⇐2166

Trial court in income tax refund action arising out of Internal Revenue Service's disallowance of claimed business expense deductions erred in finding that "blizzard" of bills, chits, etc., established amounts, dates and places of expenditures as claimed by taxpayers rather than requiring taxpayers to substantiate each expenditure with specificity required by law. 26 U.S.C.A. (I.R.C.1954) §§ 162, 274, 274(a, d, e); Fed.Rules Civ. Proc. rule 52(a), 28 U.S.C.A.

Appeals from the United States District Court for the Northern District of Texas.

Before BROWN, Chief Judge, and GODBOLD and CLARK, Circuit Judges.

JOHN R. BROWN, Chief Judge:

During a period of years, 1964–67, Taxpayers Hillcrest State Bank (Hillcrest) and its Chairman of the Board, Dowell, incurred a great number and variety of entertainment and travel expenses which they attempted to deduct as business expenses. When the Commissioner of Internal Revenue disallowed the deductions, Taxpayers commenced refund suits in United States District Court. The District Court found that refunds were called for because all deductions were properly taken as ordinary and necessary business expenses under § 162 of the Internal Revenue Code of 1954 and were sufficiently substantiated under § 274(d). 370 F.Supp. 69 (N.D. Tex.1974).

We hold that the District Court erred in its application of § 274(d)'s substantiation requirements. We vacate the District Court's judgments and remand for reconsideration in accordance with our opinion.

Hillcrest is a Texas corporation with its principal office in Dallas, Texas. During the years in issue, Dowell was Hillcrest's President and Chairman of its Board of Directors. In addition, Dowell maintained a ranch and an insurance, loan and real estate business in or near Greenville, Texas, some 50 miles from Dallas.

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During the years in question, Hillcrest paid club bills, hotel bills, airline ticket charges and other travel charges incurred by or on behalf of Dowell. These payments were charged to Hillcrest's "dues, subscriptions and entertainment" account and taken as deductions by Hillcrest on its tax returns for those years. Hillcrest additionally paid Dowell a total of $150.00 per month in the form of two $75.00 checks, one of which was charged to Hillcrest's "traveling" account, the other of which was charged to its "dues, subscriptions and entertainment" account. Hillcrest similarly deducted the yearly totals of these amounts. The IRS disallowed these deductions by Hillcrest and taxed the amounts as dividends to Dowell.

During the same period, Dowell made expenditures from his personal funds in connection with his personal business interests and listed such expenditures under the headings "travel and entertainment," "fees," "auto expenses" and "advertising." On his tax returns for those years, Dowell took portions of these expenditures as deductions, most of which deductions were disallowed by the IRS.

The IRS assessed additional income tax and interest against Hillcrest for the years 1964 through 1967 in the total amount of $21,655.15. After Hillcrest's refund claims were disallowed, Hillcrest filed timely suits for refunds for the years 1964–65 and 1966–67, respectively. The IRS also assessed additional income tax and interest against Dowell [1] for the years 1964 through 1967 in the total amount of $31,861.44. After Dowell's refund claims were similarly disallowed, Dowell also filed timely suits for refunds for the same years. The four consolidated cases were tried before the District Court without a jury. Upon its memorandum opinion the District Court rendered separate judgments in favor of Hillcrest and Dowell. The Government appeals.

At trial, a number of bills, chits and other papers related to Dowell's travel and meals with other persons were admitted into evidence. Many of these bills, however, contained only monthly aggregates of individual expenditures, without specification of time, place or individual amount. Almost all of the exhibits failed to contain a contemporaneous record of the business purpose or business relationship of the person or persons entertained. To supply the latter elements, Taxpayers brought in numerous witnesses who testified as to Dowell's dedication to and total absorption in the business affairs of Hillcrest and his own business interests. But while most of the witnesses testified to having been entertained by Dowell at various "business" lunches, etc., most of them could not identify with particularity any specific date or dates on which they had been entertained, the place at which they had been entertained on any given date, the specific business discussed, or the amount of expense incurred by Dowell, nor could Dowell fill in the gaps.

Entertainment and travel expense deductions are governed by the general provisions of § 162,[2] which require the expense to be ordinary and necessary

1. Evelyn Dowell is also a party to the actions as a result of her having filed joint income tax returns with her husband during the years at issue.

2. 26 U.S.C.A.

§ 162. Trade or business expenses

(a) In general.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

and to be business-related. The District Court had a great deal of evidence before it which fully supports its conclusion that Dowell, personally, was totally absorbed in conducting Hillcrest's and his own business, that such expenses were common in the banking industry, and in fact contributed to Hillcrest's growth. We think, in this case, that there is sufficient circumstantial evidence to satisfy the requirements of § 162. *See Andress v. Commissioner*, 51 T.C. 863, 868 (1969), *aff'd* 5 Cir., 1970, 423 F.2d 679. We do not understand the Government to seriously challenge this phase of the District Court's holding.

Rather, the central issue on appeal is whether amounts deducted as business expenses for travel and entertainment by Dowell and Hillcrest were properly substantiated as required by § 274(d).[3] If these deductions were not substantiat-

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Int.Rev.Code of 1954, as amended.

3. 26 U.S.C.A.

§ 274. Disallowance of certain entertainment, etc., expenses

(a) Entertainment, amusement, or recreation.—

(1) In general.—No deduction otherwise allowable under this chapter shall be allowed for any item—

(A) Activity.—With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business, or

(B) Facility.—With respect to a facility used in connection with an activity referred to in subparagraph (A), unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business,

and such deduction shall in no event exceed the portion of such item directly related to, or, in the case of an item described in subparagraph (A) directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), the portion of such item associated with, the active conduct of the taxpayer's trade or business.

(2) Special rules.—For purposes of applying paragraph (1)—

(A) Dues or fees to any social, athletic, or sporting club or organization shall be treated as items with respect to facilities.

(B) An activity described in section 212 shall be treated as a trade or business.

(d) Substantiation required.—No deduction shall be allowed—

(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

(2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, or

(3) for any expense for gifts,

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift. The Secretary or his delegate may by regulations

ed, Dowell cannot deduct expenditures made in connection with his own businesses, and Hillcrest's payments of Dowell's expenditures on its behalf plus the $150.00 per month which it paid directly to Dowell are income to Dowell. Also, if these deductions were not substantiated, the Government contends that the payments by Hillcrest of Dowell's expenditures and the $150.00 per month it paid directly to Dowell constitute a constructive dividend and are therefore not deductible by Hillcrest.

Section 274 represents a Congressional resolution of competing policy considerations. Much opposition is voiced to entertainment deductions altogether because the "average" taxpayer is not able to deduct the cost of his meals or entertainment, and it is therefore thought inequitable ever to permit the often affluent businessman to do so.

In addition, the deduction was often abused by overestimating the amount of the expense or assigning dubious business purposes to what were essentially personal entertainment or travel expenditures, thus undermining public confidence in the impartial imposition of taxes. Some thought the blame for this abuse started on Broadway and ended at Foley Square. In *Cohan v. Commissioner of Internal Revenue*, 2 Cir., 1930, 39 F.2d 540, Judge Learned Hand, writing the opinion of the Court, held that where evidence indicated that the taxpayer had incurred deductible entertainment and travel expenses, but these amounts could not be determined with exactitude, the Court—in an effort to be equitable—must make "as close an approximation as it can" rather than disallow the deduction entirely. Id. at 543–44.

On the other hand, it is common knowledge that business competition is not based on price alone. Customers are naturally influenced by the services they receive incidental to the central goods-or-services transaction. Because such incidentals often depend in large part on

provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations.

(e) Specific exceptions to application of subsection (a).—Subsection (a) shall not apply to—

(1) Business meals.—Expenses for food and beverages furnished to any individual under circumstances which (taking into account the surroundings in which furnished, the taxpayer's trade, business, or income-producing activity and the relationship to such trade, business, or activity of the persons to whom the food and beverages are furnished) are of a type generally considered to be conducive to a business discussion.

(2) Food and beverages for employees.—Expenses for food and beverages (and facilities used in connection therewith) furnished on the business premises of the taxpayer primarily for his employees.

(3) Expenses treated as compensation.—Expenses for goods, services, and facilities, to the extent that the expenses are treated by the taxpayer, with respect to the recipient of the entertainment, amusement, or recreation, as compensation to an employee on the taxpayer's return of tax under this chapter and as wages to such employee for purposes of chapter 24 (relating to withholding of income tax at source on wages).

(4) Reimbursed expenses.—Expenses paid or incurred by the taxpayer, in connection with the performance by him of services for another person (whether or not such other person is his employer), under a reimbursement or other expense allowance arrangement with such other person, but this paragraph shall apply—

(A) where the services are performed for an employer, only if the employer has not treated such expenses in the manner provided in paragraph (3), or

(B) where the services are performed for a person other than an employer, only if the taxpayer accounts (to the extent provided by subsection (d)) to such person.

Int.Rev.Code of 1954, as amended.

the personalities of the seller's representatives, informal social-like contact may be critically important. Such contacts may well form the basis on which a business finally decides with whom to deal. The social aspect of courting potential customers, increasing volume from current customers, or even persuading a competitor's customers to change their allegiance is an accepted part of American business which is not thought to corrupt business men and women. Further, if the deduction were denied altogether, it is probably the small competitor who would most likely be hurt—because economies-of-scale are available to larger competitors who are more apt to be able to absorb nondeductible costs.

In order to understand fully § 274's resolution of these considerations, it is important to be aware of its legislative development. President Kennedy, in 1962, took the position that no entertainment expenses should be allowed.[4] Congress, however, declined to go that far.[5] Instead, it narrowed the class of entertainment and travel expenses deductible under § 162, *see* § 274(a) and (e), and established strict substantiation requirements for *all* entertainment and travel deductions, *see* § 274(d), thus curtailing abuse of the *Cohan* rule, which permitted taxpayers to estimate entertainment and travel expenses.[6]

Congress thus declared its intent to disallow entertainment deductions based solely on a taxpayer's "own unsupported, self-serving testimony." Estimates were not to be deductible—corroboration was required. See note 6, *supra*.

Section 274(d) provides that the taxpayer must substantiate *all* expenses for

4. *See* 1962 U.S.Code Cong. and Admin.News, p. 3327.

5. The Treasury brought to the attention of Congress that widespread abuses have developed through the use of the expense account. In his tax message to the Congress last year, the President stated his conviction that entertainment and related expenses, even though having a connection with the needs of business, confer substantial tax-free personal benefits on the recipients, and that in many instances deductions are obtained by disguising personal expenses as business expenses. He recommended that the cost of such business entertainment and the maintenance of entertainment facilities be disallowed in full as a tax deduction and that restrictions be imposed on the deductibility of business gifts and travel expenses.

* * * * * *

After careful consideration of the proposal, your committee has concluded that deductions for entertainment and traveling expenses and business gifts should be restricted to prevent abuses. The committee agrees that this abuse of the tax law should not be condoned, but on the other hand it does not believe that complete disallowance as recommended by the President is the proper solution to the problem. Rather, your committee is convinced that expenses incurred for valid business purposes should not be discouraged since such expenses serve to increase business income, which in turn produces additional tax revenues for the Treasury.

S.Rep.No.1881, 87 Cong., 2d Sess., at 24–25 (1962–3 Cum.Bull., at 730–31), U.S.Code Cong. & Admin.News 1962, p. 3327.

6. This provision is intended to overrule, with respect to such expenses the so-called *Cohan* rule. In the case of *Cohan v. Commissioner*, 39 F.2d 540 (C.A.2d, 1930), it was held that where the evidence indicated that a taxpayer had incurred deductible expenses but their exact amount could not be determined, the court must make "as close an approximation as it can" rather than disallow the deduction entirely. Under your committee's bill, the entertainment, etc., expenses in such a case would be disallowed entirely.

H.Rep.No.1447, 87th Cong., 2d Sess., at 23 (1962–3 Cum.Bull., at 427); S.Rep.No.1881, *supra*, at 35 (1962–3 Cum.Bull., at 741), U.S. Code Cong. & Admin.News 1962, p. 3337.

travel, entertainment, or gifts—whether falling within the requirements of § 274(a) or not—

by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift.

Pursuant to authority granted in § 274(h), Treasury Regulation 26 CFR § 1.274–5 [7] amplifies these substantiation requirements. It provides that each element of each separate expenditure be supplied either through adequate records or through the taxpayer's own statement plus corroborative evidence sufficient to establish each element. § 1.274–5(c)(3)(i) and (ii). These requirements are based solidly on legislative history.[8]

In short, § 274(d) requires taxpayers to substantiate—either through adequate records or through their own statements corroborated by other evidence—each and every element (amount, date, place, business purpose, and business relationship) of each and every expenditure in order to claim entertainment and travel expenses allowed under § 274 and § 162. If such substantiation is lacking, the deduction is to be disallowed entirely. Through this statute and the expected regulations, Congress did not intend to chill the legitimate and reasonable use of business entertainment and travel, recognizing its function in American business. Its purpose was to eliminate as far as possible abuses of the deduction.

7. *§ 1.274–5 Substantiation requirements.*

* * * * * *

(b) *Elements of an expenditure*—(1) *In general.* Section 274(d) and this section contemplate that no deduction shall be allowed for any expenditure for travel, entertainment, or a gift unless the taxpayer substantiates the following elements for each such expenditure:

(i) Amount;

(ii) Time and place of travel or entertainment (or use of a facility with respect to entertainment), or date and description of a gift;

(iii) Business purpose; and

(iv) Business relationship to the taxpayer of each person entertained, using an entertainment facility or receiving a gift.

(2) *Travel.* The elements to be proved with respect to an expenditure for travel are—

(i) *Amount.* Amount of each separate expenditure for traveling away from home, such as cost of transportation or lodging, except that the daily cost of the traveler's own breakfast, lunch, and dinner and of expenditures incidental to such travel may be aggregated, if set forth in reasonable categories, such as for meals, for gasoline and oil, and for taxi fares;

(ii) *Time.* Dates of departure and return for each trip away from home, and number of days away from home spent on business;

(iii) *Place.* Destinations or locality of travel, described by name of city or town or other similar designation; and

(iv) *Business purpose.* Business reason for travel or nature of the business benefit derived or expected to be derived as a result of travel.

(3) *Entertainment in general.* Elements to be proved with respect to an expenditure for entertainment are—

(i) *Amount.* Amount of each separate expenditure for entertainment, except that such incidental items as taxi fares or telephone calls may be aggregated on a daily basis;

(ii) *Time.* Date of entertainment;

(iii) *Place.* Name, if any, address or location, and designation of type of entertainment, such as dinner or theater, if such information is not apparent from the designation of the place;

(iv) *Business purpose.* Business reason for the entertainment or nature of business benefit derived or expected to be derived as a result of the entertainment and, except in the case of business meals described in section 274(e)(1), the nature of any business discussion or activity;

(v) *Business relationship.* Occupation or other information relating to the person or persons entertained, including name, title, or other designation, sufficient to establish business relationship to the taxpayer.

* * * * * *

(c) *Rules for substantiation*—(1) *In general.* A taxpayer must substantiate each element of an expenditure (described in paragraph (b) of this section) by adequate records or by sufficient evidence corroborating his own statement except as otherwise provided in this section. Section 274(d) contemplates that a taxpayer will maintain and produce such substantiation as will constitute clear proof of an expenditure for travel, entertainment, or gifts referred to in section 274. A record of the elements of an expenditure made at or near the time of the expenditure, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall. Thus, the corroborative evidence required to support a statement not made at or near the time of the expenditure must have a high degree of probative value to elevate such statement

and evidence to the level of credibility reflected by a record made at or near the time of the expenditure supported by sufficient documentary evidence. The substantiation requirements of section 274(d) are designed to encourage taxpayers to maintain the records, together with documentary evidence, as provided in subparagraph (2) of this paragraph. To obtain a deduction for an expenditure for travel, entertainment, or gifts, a taxpayer must substantiate, in accordance with the provisions of this paragraph, each element of such an expenditure.

(2) *Substantiation by adequate records*—(i) *In general.* To meet the "adequate records" requirements of section 274(d), a taxpayer shall maintain an account book, diary, statement of expense or similar record (as provided in subdivision (ii) of this subparagraph) and documentary evidence (as provided in subdivision (iii) of this subparagraph) which, in combination, are sufficient to establish each element of an expenditure specified in paragraph (b) of this section. It is not necessary to record information in an account book, diary, statement of expense or similar record which duplicates information reflected on a receipt so long as such account book and receipt complement each other in an orderly manner.

* * * * * *

(3) *Substantiation by other sufficient evidence.* If a taxpayer fails to establish to the satisfaction of the district director that he has substantially complied with the "adequate records" requirements of subparagraph (2) of this paragraph with respect to an element of an expenditure, then, except as otherwise provided in this paragraph, the taxpayer must establish such element—

(i) By his own statement, whether written or oral, containing specific information in detail as to such element; and

(ii) By other corroborative evidence sufficient to establish such element.

If such element is the description of a gift, or the cost, time, place, or date of an expenditure, the corroborative evidence shall be direct evidence, such as a statement in writing or the oral testimony of persons entertained or other witness setting forth detailed information about such element, or the documentary evidence described in subparagraph (2) of this paragraph. If such element is either the business relationship to the taxpayer of persons entertained or the business purpose of an expenditure, the corroborative evidence may be circumstantial evidence.

8. In the Committee Reports, H.Rep.No.1447, *supra*, at 23 (1962-3 Cum.Bull., at 427), it is stated:

* * * the degree of corroboration required to support a claimed deduction will vary as respects the business relationship and purpose, the time and place, and the amount of the expense. Thus, oral testimony of the taxpayer together with circumstantial evidence available, may be considered "sufficient evidence" for the purpose of establishing the business purpose required under the new provision. However, oral testimony of the taxpayer plus more specific evidence would be required to be "sufficient evidence" as to the amount of an expense.

The District Court found that the times, places and amounts of expenditures had been clearly provided by "a virtual blizzard of bills, chits and other papers relating to Dowell's meals with other persons."[9] The District Court also determined that those elements for which adequate records had not been provided, namely, the business purpose and business relationship of those entertained, had been adequately substantiated by Dowell's own testimony as corroborated by the oral testimony of some 20 witnesses. These findings pertained to all three types of expenditures in question: (i) hotel, club, airline and travel bills incurred by Dowell and paid directly by Hillcrest, (ii) travel and miscellaneous expenditures made by Dowell for which he was reimbursed by Hillcrest at a flat rate of $150.00 a month, and (iii) travel, fees, entertainment and other expenses incurred and paid by Dowell himself in connection with his own various business interests. The common determination to be made is whether any expenditure in any of the categories was adequately substantiated as required by § 274(d).

The District Court heard substantial testimony that all of Dowell's activities were business-oriented and that nearly all of his activities were directed toward increasing the business of Hillcrest. The District Court determined that Dowell—a dynamo without a doubt—was totally absorbed in business activity and that therefore the element of business purpose was established for each expenditure. The District Court is entitled to credit testimony, and its finding that Dowell was totally a creature—or captive—of the business world, thereby establishing business purpose, is supported by the record. However, we anticipate that it will be only rarely that a taxpayer will be able to establish business purpose for each expenditure the way Dowell did below.

The District Court's finding that the "blizzard" of bills, chits, etc. established the amounts, dates and places of expenditures misapprehended the specificity with which a taxpayer must substantiate each expenditure deducted under § 274(d). It is apparent that the District Court was snowed under by the volume of paper in evidence and chose not to wade through it to make an expenditure-by-expenditure determination, instead making a general determination that the deductions were substantiated. Yet, this is just what § 274(d) requires the District Court to do. A less stringent examination would echo the approach under the former *Cohan* rule and clearly defeat the purpose of § 274(d).[10] We need not and do not find the District

9. 370 F.Supp. at 71. There were over 1,700 bills, chits and other memorabilia in evidence in this case. We decline to fly through this blizzard, mentioning only a few examples for the District Court's guidance on remand.

10. The District Court's reliance, 370 F.Supp. at 73–74, on the case of *LaForge v. Commissioner of Internal Revenue*, 2 Cir., 1970, 434 F.2d 370, as controlling authority for its determination that the witness' testimony was sufficiently corroborative of the elements of each expenditure, is misplaced. In *LaForge*, the taxpayer was a surgeon who regularly bought lunches in the hospital cafeteria for his assistants. He kept no written records itemizing the cost of the lunches, but deducted on his income tax returns $2.00 for each day of the hospital schedule. Hospital rules forbade the cafeteria cashier from issuing receipts, but she testified that taxpayer regularly spent $2.65 to $3.00 each day for the lunches. The Tax Court ruled that the taxpayer's and the cashier's testimony did not fulfill the substantiation requirements of the regulations, § 1.274–5(c)(3), and disallowed the deduction. On appeal the taxpayer contended that the regulation as it then existed, by requiring a written statement, disregarded the alternative statutory requirement of substantiation by "sufficient evidence corroborating his own statement." (Subsection (c)(3) of the Regulations was subsequently amended to allow for a taxpayer's oral statement.) The Second Circuit held that "To require a written statement itemizing each expenditure is, in effect, to compel the taxpayer to maintain 'adequate records' and thereby to dismiss from the statute one element of its disjunctive substantiation requirements." Id. at 372. The Court then held that although properly corroborative oral testimony may constitute adequate substantiation, the taxpayer's testimony was not "sufficiently precise" under the regulation, since he had not presented evidence as to the nondeductible cost of his own lunches. The case was accordingly remanded to the Tax Court to allow the taxpayer to prove the cost of his own meals as a part of his testimonial substantiation.

The factual distinctions between *LaForge* and the instant case are apparent. The amounts in *LaForge* were much smaller, all of the claimed expenditures were in the same cafeteria, and LaForge presented corroboration of his own statement concerning the amounts, dates and business relationships with respect to each expenditure. The entertainees were all from a small, indentifiable group, and their business relationship to the taxpayer was clear. In our case, however, Dowell has not adequately substantiated the elements of his expenditures, and the large number of expenditures, the variety of places at which Dowell entertained, and the many different people entertained by him render the possibilities for abuse infinitely greater than in *LaForge*.

Moreover, in *Hughes v. Commissioner of Internal Revenue*, 2 Cir., 1971, 451 F.2d 975, 979, the Second Circuit, in explaining its decision in *LaForge*, stated: "The significance of *LaForge* is that, even though a written statement may not be required for substantiation, the corroborative evidence must nevertheless establish each statutory element—amount, time, place and purpose—of the expenditure with precision and particularity." *Accord, Handelman v. Commissioner of Internal Revenue*, 2 Cir., 1975, 509 F.2d 1067. It is just this "precision and particularity" which is completely absent from the "corroborative" testimony of the taxpayers' witnesses in the instant case.

11. *Battelstein Investment Co. v. United States*, 5 Cir., 1971, 442 F.2d 87; *Continental Motors Corp. v. Continental Aviation Corp.*, 5 Cir., 1967, 375 F.2d 857; *Fulton National Bank v. Tate*, 5 Cir., 1966, 363 F.2d 562.

Court's findings of fact to be clearly erroneous. Cf. F.R.Civ.P. 52(a). Rather, as we have many times done,[11] they cannot be accepted since the District Court applied the wrong legal standard to the evidence before it in concluding that the expenditures were adequately substantiated under § 274(d).

It is evident from Dowell's testimony alone, R. at 151–56, that some of the statements introduced from clubs such as the Texas Club or credit services such as American Express were monthly statements without itemization of the persons entertained, specific dates or amounts (or, in the case of the American Express stubs, the location at which the expense was incurred). *See* Def. Ex. 3. Even if tickets listing separate expenditures were normally returned with the monthly statements, as in the case of American Express, for example, it is apparent that Hillcrest either did not retain such tickets or chose not to offer them in evidence. R. at 153; Def. Ex. 3. Dowell did not keep an appointment book or diary. R. at 152, so it is clear, at least with respect to those expenditures listed as monthly statements, that the "adequate records" requirement was not fulfilled with respect to *each separate expenditure* included in the monthly aggregates. In many cases, it appears that Dowell did not establish the elements of these expenditures by "other sufficient evidence." Dowell testified, for example, R. at 153, 156, that he could not recall the dates on which the charges from the Texas Club and American Express were incurred. The witnesses who testified in his behalf were generally no more specific. While most of these wit-

nesses testified to having periodic business luncheons, dinners or meetings with Dowell at numerous named clubs or restaurants, and provided general descriptions as to the type of business usually discussed at such functions, most could not identify any particular dates on which they had dined with Dowell, where they had eaten on any given day, or the amount of any bill.[12]

Similar in legal analysis is substantiation of the business relationship of particular entertainees to the Taxpayers. The substantiation statute says "the"—not "a"—business relationship. And the business relationship cannot be ascertained unless the taxpayer establishes the identity of his entertainee—whether by name, title or other specific designation. If such identification were not required, the element of business relationship would be redundant, since "business purpose" almost necessarily requires showing "a" business relationship.

The District Court's failure to adhere to the precise requirements of the statute and Regulations reopens the door to the very type of tax abuse which Congress intended § 274 to foreclose. Such application of the statute was error going to the very heart of the case and the critical fact findings. Accordingly, the judgments must be vacated and the case remanded to determine in accordance with applicable principles whether each expenditure was adequately substantiated.

The same principles apply to the $150.00 which Hillcrest paid Dowell each month to cover his miscellaneous travel and entertainment expenses. Dowell testified, R. at 147–48, that he used this money for such out-of-pocket expenses as parking in town or at the airport, for tips, taxicabs, for telephone calls or for buying "somebody coffee or Coca Colas or whatnot." This is the only substantiation offered by Dowell or Hillcrest with regard to these out-of-pocket expenses. Dowell testified, R. at 170–71, that the money was spent solely at his discretion, and that he "never accounted to anyone" for the expenditure of those funds.

The District Court, in reviewing the facts relevant to these out-of-pocket expenses, determined that although Dowell "did not keep a record of every dime inserted into parking meters," such substantiation was impractical and not required by the statute and Regulations. 370 F.Supp. at 75. We see no reason, however, why the taxpayer should not be held to the same substantiation requirements regarding these miscellaneous expenditures as for the expenditures previously discussed, especially since the Regulations [13] recognize the practical difficulties by allowing aggregations in re-

* * * * * *

(b)(2) *Travel.* The elements to be proved with respect to an expenditure for travel are—

(i) *Amount.* Amount of each separate expenditure for traveling away from home, such as cost of transportation or lodging, except that the daily cost of the traveler's own breakfast, lunch, and dinner and of expenditures incidental to such travel may be aggregated, if set forth in reasonable categories, such as for meals, for gasoline and oil, and for taxi fares;

* * * * * *

12. Indeed, some of the documentary evidence introduced with respect to entertainment expenditures indicates that the expenditures may well have been purely personal in nature. For example, the Rafters Club statement of February 1967 included in Plf. Ex. 7 contains three charge tickets signed by Dowell on three separate days which reflect only one drink on each ticket. Plf. Ex. 4 contains a statement from Neiman Marcus Department Store, paid in June 1964, in the amount of $255.00.

13. 26 C.F.R. § 1.274–5 Substantiation Requirements

alistic related categories. Even though Dowell was not required under the Regulations to record every dime he spent, it appears that he did not keep *any* record of *any* dime or aggregate of dimes spent anywhere. He kept no diary or account book, R. at 152, and offered no corroboration of his own statement as to the use made of the $150.00 which he received every month from Hillcrest. Since Dowell did not keep a diary or account book, and since no other attempt was made to demonstrate how much he might have spent for telephone calls, or for coffee and cokes for customers, etc., Dowell's own testimony was insufficient without proper corroboration to substantiate the business use of these funds. The District Court erred in not requiring adequate substantiation under the Regulations as to the use Dowell made of the $150.00 which he received from Hillcrest each month.

The Government further contends that the amounts expended by Hillcrest to cover Dowell's expenditures, including the $150.00 paid directly to Dowell each month, constitute a "constructive dividend" from Hillcrest to Dowell because they conferred an "economic benefit on the stockholder without the expectation of repayment," *Gibbs v. Tomlinson,* 5 Cir., 1966, 362 F.2d 394, and that they are thus not deductible by Hillcrest. The District Court did not consider this issue, since it found that the monthly payments by Hillcrest to Dowell were used to reimburse properly substantiated expenditures by Dowell on behalf of Hillcrest and therefore were deductible. Since we lack both the necessary findings of fact and those made in the light of applicable principles to decide whether Hillcrest's payments to Dowell constituted as to Hillcrest constructive dividends, we leave this issue initially to the decision of the District Court on remand. *See Gibbs v. Tomlinson, supra; Paramount-Richards Theatres, Inc. v. Commissioner of Internal Revenue,* 5 Cir., 1946, 153 F.2d 602.

Vacated and remanded.

(3) *Entertainment in general.* Elements to be proved with respect to an expenditure for entertainment are—

(i) *Amount.* Amount of each separate expenditure for entertainment, except that such incidental items as taxi fares or telephone calls may be aggregated on a daily basis;

* * * * * *

(c)(6)(i)(b) *Aggregation.* Except as otherwise provided in this section, the account book, diary, statement of expense, or similar record required by subparagraph (2)(ii) of this paragraph shall be maintained with respect to each separate expenditure and not with respect to aggregate amounts for two or more expenditures. Thus, each expenditure for such items as lodging and air or rail travel shall be recorded as a separate item and not aggregated. However, at the option of the taxpayer, amounts expended for breakfast, lunch, or dinner, may be aggregated. A tip or gratuity which is related to an underlying expense may be aggregated with such expense. For other provisions permitting recording of aggregate amounts in an account book, diary, statement of expense or similar record see paragraph (b)(2)(i) and (b)(3) of this section (relating to incidental costs of travel and entertainment).

Adm. Office, U.S. Courts—West Publishing Company, Saint Paul, Minn.

Appendix II

United States Court of Appeals
For the Fifth Circuit

October Term, 1974

No. 74-3057

D. C. Docket Nos. CA 3-3521-C, 3-3522-C & 3-5474-C, & 3-5475-C – Consolidated in D. C.

CAM F. DOWELL, JR., EVELYN DOWELL and HILLCREST STATE BANK,
Plaintiffs-Appellees,

versus

UNITED STATES OF AMERICA,
Defendant-Appellant.

Appeals from the United States District Court for the Northern District of Texas

Before BROWN, Chief Judge, and GODBOLD and CLARK, Circuit Judges.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, vacated; and that this cause be, and the same is hereby remanded to the said District Court for reconsideration in accordance with the opinion of this Court;

It is further ordered that plaintiffs-appellees pay to defendant-appellant, the costs on appeal to be taxed by the Clerk of this Court.

November 7, 1975

Issued as Mandate:

Appendix III

U.S. COURT OF APPEALS
FILED
DEC 29 1975
EDWARD W. WADSWORTH
CLERK

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 74-3057

CAM F. DOWELL, JR., EVELYN DOWELL
& HILLCREST STATE BANK

Plaintiffs-Appellees,

versus

UNITED STATES OF AMERICA,
Defendant-Appellant.

Appeal from the United States District Court for the Northern District of Texas

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ON PETITION FOR REHEARING
(December 29, 1975)

Before BROWN, Chief Judge, GODBOLD and CLARK, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby DENIED.

Appendix IV

Cam F. DOWELL, Jr., and Evelyn Dowell

v.

UNITED STATES of America
(two cases).

HILLCREST STATE BANK

v.

UNITED STATES of America
(two cases).

Nos. CA3-3521-C, CA3-3522-C, CA3-5474-C and CA3-5475-C.

United States District Court,
N. D. Texas,
Dallas Division.
Jan. 30, 1974.

Bank and bank president brought actions against the United States for refund of federal income taxes. The District Court, William M. Taylor, Jr., Chief Judge, held that oral testimony and circumstantial evidence corroborating written evidence and bank president's statement concerning amount, time and place, business purpose and business relationship of contested entertainment deductions were sufficient to show business purpose and business relationship of amounts expended for entertainment; that bank was entitled to deduction for amount of monthly travel allowance paid to bank president for travel between suburb where bank was located and central business district; and that amounts expended by bank president for travel to another city where president maintained farm and an insurance, loan and real estate business and for long range travel were deductible.

Order Accordingly.

1. Internal Revenue – 2166

Oral testimony and circumstantial evidence corroborating written evidence and bank president's statement concerning

amount, time, place, business purpose and business relationship of luncheons and dinners satisfactorily substantiated that president's entertainment expenses had business purpose and relationship and justified bank president's deduction of such entertainment expenses in computing income taxes. 26 U.S.C.A. (I.R.C.1954) §§ 274, 274(d).

2. Internal Revenue – 341

Amount which bank paid for meals of bank president when he did not entertain a guest for business purposes was chargeable to bank president as ordinary income in the form of additional compensation.

3. Internal Revenue – 341, 555

Where bank president's business lunches in central business district were ordinary and necessary to conduct of business, monthly travel allowance paid by bank to bank president for his travel between suburb where bank was located and central business district was deductible as a business expense by bank and was not chargeable to bank president as ordinary income, even though bank president did not keep record of out-of-pocket expenses for such travel. 26 U.S.C.A. (I.R.C.1954) §§ 274, 274(d).

4. Internal Revenue – 555

Amounts expended by taxpayer in travelling about fifty miles to another city where he maintained farm and an insurance, loan and real estate business and where bank of which he was chairman of board was located were deductible by taxpayer as business expenses, with exception of amounts expended for gasoline represented by charge slips signed by taxpayer's sons. 26 U.S.C.A. (I.R.C.1954) §§ 274, 274(d).

5. Internal Revenue – 555

Bank president was entitled to deduct expenses of trips to business meetings, trips to inspect property he was considering buying and journeys for purpose of visiting state and federal banking officials as ordinary and necessary and directly related to conduct of his business. 26 U.S.C.A. (I.R.C.1954) §§ 274, 274(d).

6. Internal Revenue 2121

In action for refund of federal income taxes, Government's position would be taken as correct with respect to transactions concerning which taxpayer failed to produce any evidence.

Ethan B. Stroud, Robert W. Ryan, Jr., L. Vance Stanton, Richard D. Pullman, Stroud & Smith, Dallas, Tex., for plaintiffs.

Frank D. McCown, U.S. Atty., Martha Joe Stroud, Asst. U.S. Atty., Charles G. Barnett and William W. Guild, Tax Div., Dept. of Justice, for defendant.

MEMORANDUM OPINION

WILLIAM M. TAYLOR, Jr., Chief Judge.

Hillcrest State Bank of Dallas, Texas, and its president since 1956, Cam F. Dowell, Jr.,[1] sued the United States for the refund of some $54,000.00 in federal income taxes.[2]

The key question in these consolidated cases, which were tried before the Court, is whether the Internal Revenue Service correctly disallowed most of the taxpayers' claimed deductions for the costs of Dowell's travel and his meals with customers and prospective customers of the bank, as well as bank directors and government officials. Additionally, Dowell deducted as business expenses some of his travel costs and other costs connected with his business interests in Greenville, Texas.

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[1] In CA 3-3521 and CA 3-5474, Dowell and his wife Evelyn Dowell are the plaintiffs, since they filed joint returns. Hereafter, "Dowell" will refer to both Mr. and Mrs. Dowell.

[2] Dowell is suing for a total of $31,861.44, including interest. In CA 3-3522 and CA 3-5475, Hillcrest State Bank (hereafter "Hillcrest" or "the bank") is suing for a total of $21,655.15 including interest. All suits allege that the taxes in question were erroneously, illegally and wrongfully assessed and collected. Years in question are 1964 through 1967. Plaintiffs timely but unsuccessfully filed claims for refund with the IRS. Subsequently minor amounts were conceded by stipulation.

The defendant maintains, in a nutshell, that the expenses were not substantiated as required by § 274(d) of the Internal Revenue Code and regulations promulgated thereunder.[3] The plaintiffs insist that the deductions were wholly proper.

I find that, with certain exceptions discussed below, the deductions were for ordinary and necessary business expenses and where satisfactorily substantiated; the taxpayers will be allowed to recover refunds.

I.

DOWELL'S ENTERTAINMENT EXPENSES

Section 274 permits a taxpayer to deduct the cost of business-related entertainment, such as luncheons and dinners, provided there is substantiation "by adequate records or by sufficient evidence corroborating his own statement" of (1) amount, (2) time and place, and (3) business purpose of the expense and (4) the business relationship of the taxpayer and

[3] All statutory references are to the Internal Revenue Code of 1954, Title 26 United States Code, unless otherwise noted. The section in question reads in pertinent part:

> (d) Substantiation required. – No deduction shall be allowed–
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> (1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),
>
> (2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, or
>
> (3) for any expense for gifts,
>
> unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift. The Secretary or his delegate may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations. *See* also 26 C.F.R. § 1.274-5 generally.

the guest. Additionally, the cost of dues of entertainment facilities, such as private clubs, may be deducted if the club is used principally for furthering the taxpayer's business and the expenditures are directly related to the active conduct of the business.

[1] In this case there is no question as to the amount, time and place of Dowell's entertainment. A virtual blizzard of bills, chits and other papers relating to Dowell's meals with other persons was admitted into evidence. They clearly show the place, date and total amount charged. The missing elements, then, are the business purpose and business relationship. Although these are not always shown by Dowell's records, I find them unmistakably supplied by the testimony of numerous witnesses, satisfying the requirement in § 274 of substantiation "by sufficient evidence corroborating [the taxpayer's] own statement."[4]

Among the stacks of papers in evidence is a sheet from a memo pad with a sketch of the Hillcrest State Bank building and the slogan, "That's my bank." As far as Dowell is concerned, truer words were never spoken. Dowell is more than a banker: he is a flesh and blood extension of Hillcrest State Bank. From the evidence in this case, he devoted practically every waking moment of every weekday, and frequent weekends, to his bank. The bank was Dowell's sole avocation. Indeed, during the years

[4] Similarly, Treasury Regulations, 26 C.F.R. § 1.274-5(b)(3)(v), suggest that business relationship need not be shown in black and white, but rather may be established by "occupation *or other information* relating to the person or persons entertained including name, title *or other designation* sufficient to establish business relationship to the taxpayer" [emphasis added]. Further, § 1.274-5(c)(3), as amended after the trial of this case, provides as follows:

> If a taxpayer fails to establish to the satisfaction of the district director that he has substantially complied with the "adequate records" requirements of subparagraph (2) of this paragraph with respect to an element of an expenditure, then, except as otherwise provided in this paragraph, the taxpayer must establish such element –
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> (i) by his own statement, whether written or oral, containing specific information in detail as to such element; and
>
> (ii) by other corroborative evidence sufficient to establish such element.
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> • • • • •
>
> If such element is either the business relationship to the taxpayer of persons entertained or the business purpose of an expenditure, the corroborative evidence may be circumstantial evidence [emphasis added].

in question, Hillcrest (which is a relatively small bank in a commercial city of giant banks) grew and prospered. Deposits climbed from about $27 million to some $34 million, an increase of approximately $7 million or about 25 percent. The bank's income likewise increased during the same period. The Court is in full accord with the assessment of a deponent in this case, Donald Zale, president of the Zale Corporation and a Hillcrest director:

> Q. Would you state that the reason that the income of the Hillcrest State Bank increased was due to the efforts of Cam Dowell?
>
> A. I would say that probably ninety-nine percent of it was due to his effort . . . I think that any organization is the length, breadth and shadow of one man.
>
> Q. And in this case you would say that shadow was Mr. Dowell's shadow?
>
> A. That's correct.

It quickly became obvious at the trial that Dowell's favorite tool for cultivating new accounts for the bank was entertaining guests at lunch or dinner. These meetings were virtually an everyday occurrence, and almost always took place in a members-only luncheon club. It should be remembered that during the years in question, Texas law permitted alcoholic beverages (other than beer and wine) to be served only in private clubs, and Dowell or the bank belonged to many of Dallas' leading clubs. Testimony from witnesses clearly showed, and I find, that this was unquestionably an ordinary and necessary business practice. An officer of a competing bank, Estes A. Chancellor, explained the matter quite plainly:

> Q. What about the bank officers as a whole, what was the frequency that someone from the bank would be taking someone to lunch, frequency-wise?
>
> A. . . . I would think that at least one or more officers would be having somebody out to lunch one or more times

> a week. . . . All of our officers make calls on business development work, and if we are going to solicit a commercial account, it's quite likely that we would try to make an appointment with him to call on him about noontime and take him to lunch, because in the first place, it's free, he has an hour freedom away from his telephone and desk, so we have a better opportunity at luncheon to talk. In fact, to solicit his business, . . . you don't just walk up and say, "Why the hell don't you move your account here?" You have to talk around it a little better than that.

Unlike a noisy cafeteria or hotel coffee shop, the quiet atmosphere and availability of cocktails at a private club (usually one close to the guest's business) permitted Dowell, as Mr. Chancellor put it, to "talk around" the subject of moving the guest's account to Hillcrest.

Several businessmen who had eaten lunch or dinner with Dowell testified that there was a business purpose and business relationship in the meetings, and that they gracefully allowed Dowell to pick up the check.

Sometimes Dowell would stage larger affairs, such as receptions for banking officials, at greater cost than a simple lunch meeting. None of these appeared lavish or extraordinary; seldom if ever were wives invited and the Court is convinced that these other gatherings also were all business, except for certain gatherings to honor various political officeholders. However, these items have been eliminated from the case by stipulation of the parties.

I find that Hillcrest's directors not only approved of Dowell's conduct, but expected and required it. They knew that little if any business would come Dowell's way if he spent eight hours a day in his office waiting for customers to seek him out. It does not appear that Dowell particularly relished his regimen of business luncheons; in fact, he submitted evidence that on those rare occasions when he did not entertain a guest at lunch, he spent only about thirty-five or forty cents on his own meal.[5]

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[5] At this rate, Dowell could be expected to spend about $100.00 annually for his own meals. In keeping with the holding in LaForge v. Commissioner of Internal Revenue, discussed in the text, Dowell should be charged with receiving ordinary income in the form of additional compensation of $100.00 paid for his meals by Hillcrest during each of the years in question.

[2] The taxpayers call the Court's attention to the case of LaForge v. Commissioner of Internal Revenue, 434 F.2d 370 (2d Cir. 1970) and draw analogies to the case in question. The IRS in that suit maintained that Dr. LaForge, a surgeon, improperly deducted from his income tax the amounts he spent buying lunch for residents and interns who assisted him. The taxpayer had no written records to substantiate the amounts spent on his and his guests' lunches; instead he simply deducted a flat amount of $2.00 for each day he had lunch in the hospital cafeteria. His witness, the cafeteria cashier, testified that the doctor regularly spent from $2.65 to $3.00 on his and his guests' lunches. The IRS urged the court to disallow the deduction for noncompliance with the substantiation requirements of § 1.274-5(c)(3) of Treasury Regulations (Title 26 C.F.R.)[4] even though it had admitted the taxpayer had complied with the statutory requirement (*see* note 3 *supra*).

The Second Circuit, acknowledging that Congress had tightened the substantiation requirements because of past notorious abuses of the deductibility of business entertainment, held that the regulation's requirement of a *written* statement impermissibly went beyond the statutory requirement of substantiation by "sufficient evidence corroborating his own statement." The court found the cashier's oral substantiation of the doctor's deductions perfectly adequate substantiation. Similarly, I find the witnesses' testimony as to business purpose and business relationship with Dowell quite satisfactory and conclusive. The IRS has indicated its agreement with the correctness of the *LaForge* decision by not petitioning for certiorari and by amending the regulation in question (*see* note 4 *supra*). Moreover, it appears that Congress contemplated that oral evidence might sometimes be sufficient corroboration of business purpose and business relationship. The Senate Report on the Revenue Act of 1962 makes it clear that § 274(d) was intended to overrule legislatively the courts' so-called Cohan rule, which took its name from the case of Cohan v. Commissioner of Internal

[4] Before the amendment, the regulations provided that in the absence of "adequate records" the taxpayer must substantiate a deduction by "his own statement in writing" and by other corroborating evidence. The amendment changed the words "in writing" to "whether written or oral".

Revenue, 39 F.2d 540 (2d Cir. 1930) and which permitted a taxpayer who could prove a business expense but not its exact amount to deduct an approximate sum. The report continues:

> The requirement that the taxpayer's statements be corroborated will insure that no deduction is allowed solely on the basis of his own unsupported, self-serving testimony. However, the degree of corroboration required to support a claimed deduction will vary as respects the business relationship and purpose, the time and place, and the amount of the expense. Thus, *oral testimony of the taxpayer together with circumstantial evidence available may be considered "sufficient evidence" for the purpose of establishing the business purpose* required under the new provision. However, oral testimony of the taxpayer plus more specific evidence would be required to be "sufficient evidence" as to the amount of an expense. 1962 U.S. Code Cong. & Admin. News, pp. 3297, 3337-3338 (emphasis added).

Among all the chits, tabs, bills and other documentation of Dowell's entertainment of clients are a few unexplained items. For one thing, Mrs. Dowell's signature appears on some charge slips for very small amounts. Similarly, there is a charge for a handball game which Dowell failed to explain, admitting on cross-examination that he never held a handball. In the Court's opinion, these discrepancies are *de minimus*, amounting to less than one dollar each, but since technically they were improperly deducted the attorneys may, if the government insists, make adjustments for them when drawing the judgment.

To summarize the foregoing, the case of LaForge v. Commissioner of Internal Revenue, *supra*, is controlling as to plaintiffs' entertainment deductions. Plaintiffs have met their burden of proof by furnishing oral testimony and circumstantial evidence to corroborate written evidence and Dowell's own statement concerning the amount, time and place, business purpose and business relationship of the contested entertainment deductions.

II.

DOWELL'S BUSINESS-RELATED TRAVEL

Dowell traveled a great deal in connection with his businesses. For convenience of discussion, I will mention in order his short-range travel from the bank to downtown Dallas, medium-range travel between Dallas and Greenville, and long-range travel to various destinations.

[3] A. *Short-range travel.* Hillcrest State Bank is in University Park, an island suburb of Dallas, several miles north of the central business district. There are no dining facilities at the bank. Consequently, when Dowell had lunch with his guests, it was necessary for him to drive downtown or elsewhere in the city. Additionally, he often visited one of the large downtown banks. In lieu of reimbursing Dowell for his out-of-pocket expenses for fuel, parking, taxi fare, tips, etc., the bank paid Dowell a monthly travel allowance of $75.00. The IRS disallowed the bank's deduction of this amount, challenging whether they were ordinary and necessary business expenses and whether they were properly substantiated. Additionally, the IRS determined that the monthly allowance was ordinary income to Dowell. (The service took the same position with respect to another $75.00 monthly allowance paid to Dowell for "dues, subscriptions and entertainment.") Each month Hillcrest's board of directors approved the payments to Dowell. It follows that, having found Dowell's business lunches ordinary and necessary, I also find that his short-range travel within Dallas also was ordinary and necessary in the course of his business. He did not keep a record of every dime inserted into parking meters, it is true, but substantiation of such expenses is impractical and, I believe, not required. *See* 26 C.F.R. § 1.274-5(c)(2) and (3).

[4] B. *Medium-range travel.* In and near Greenville, Texas, about fifty miles from Dallas, Dowell maintained a farm and an insurance, loan and real estate business. He also was chairman of the board of a Greenville bank. Because of his Greenville interests, Dowell employed an accountant as his Greenville

office manager and conferred with him daily by telephone. Dowell also personally drove to Greenville at least weekly, and sometimes more frequently. Sometimes he was accompanied by Mrs. Dowell, a registered insurance solicitor. Dowell deducted automobile expenses of $7,071.18 for trips to Greenville to tend to business and to his farm. The government adjusted his deduction downward, leaving $4,669.21 in dispute, claiming a lack of substantiation that the expenses were incurred for business purposes. In keeping with my previous remarks that Dowell was strictly business, bolstered by testimony from Dowells Greenville manager that Dowell came there only on business, I find that the deductions were proper, with one exception. Any gasoline charge slips signed by Dowell's sons, as the government claims, should be excluded for lack of showing of a business purpose.

[5] C. *Long-range travel.* The only "vacations" that Dowell ever took, according to the evidence (and in consonance with what we already have learned about the man) were trips to business meetings such as annual conventions of the American Bankers Association. He sometimes made other trips to inspect property he was considering buying. Still other journeys were for the purpose of visiting state and federal banking officials in Austin and Washington. Again I believe the evidence shows that when Dowell traveled, whether on behalf of the bank or his other business interests, the travel was ordinary and necessary and directly related to the conduct of plaintiffs' business; the deductions were correct.

III.

OTHER CONTESTED DEDUCTIONS

[6] Although the parties commendably compromised a number of items, a few remained contested at the time of trial.

A. Dowell sold some shares of stock of two banks, and the IRS challenged the basis of the stock.

B. The IRS disallowed part of Dowell's deduction for bad debts on his 1966 return, since the loss was incurred on the sale of his personal automobile.

C. On his 1967 return, Dowell deducted $5,000.00 as an ordinary loss resulting from the alleged worthlessness of a motel franchise.

Dowell failed at the trail to produce any evidence about any of the foregoing transactions; thus, in each case the government's position will be taken as correct.

This opinion is filed in lieu of formal findings of fact and conclusions of law.

The attorneys for both sides are requested to submit a proposed form of judgment for the Court's consideration. In the event counsel are unable to agree, they shall notify the Court.

Appendix V

Harry G. LaFORGE and Mildred E. LaForge, Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE, Appellee.

No. 7, Docket 34607.

United States Court of Appeals, Second Circuit.

Argued Sept. 24, 1970.

Decided Nov. 10, 1970.

Proceeding to review commissioner's determination of deficiencies in income taxes for 1964 and 1965 in amounts of $704.90 and $810.60, respectively. The Tax Court, Leo Irwin, J., affirmed the commissioner, 53 T.C. 41, and taxpayer appealed. The Court of Appeals, Anderson, Circuit Judge, held that taxpayer who claimed entertainment expense deduction for expense of luncheons with business associates was entitled to deduction of amount expended after deducting from total amount maximum cost of his own lunches which were not deductible; and that portion of club dues corresponding to cost of taxpayer's own meals were "directly related" to active conduct of taxpayer's business and deductible where club dues represented cost of taxpayer's access and access of his business guests to entertainment facility.

Affirmed in part, reversed in part and remanded.

1. Internal Revenue – 157

Treasury regulation requiring taxpayer who did not compile "adequate records" of expenditures claimed as entertainment expense deductions to establish each element of expenditures by his own written statement and by other corroborating evidence was invalid for going beyond statutory requirement of

substantiation by "sufficient evidence corroborating his own statement". 26 U.S.C.A. (I.R.C.1954) § 274(d).

2. Internal Revenue – 1516

Taxpayer's oral testimony properly corroborated is sufficient to establish propriety of entertainment expense deduction. 26 U.S.C.A. (I.R.C.1954) § 274(d).

3. Internal Revenue – 1480

Taxpayer who claims entertainment expense deduction for business meal must demonstrate that cost of meal exceeded that which he would have been required to spend in any event for his sustenance. 26 U.S.C.A. (I.R.C.1954) § 274(d).

4. Internal Revenue – 555

Taxpayer who claimed entertainment expense deduction for expense of luncheons with business associates was entitled to deduction of amount expended after deducting from total amount maximum cost of his own lunches which were not deductible. 26 U.S.C.A. (I.R.C.1954) § 274(d).

5. Internal Revenue – 555

Taxpayer may deduct that fraction of total club dues that corresponds to percentage which taxpayer's expenditures for business meals taken at club represent of his total yearly expenditure for food and beverages purchased at club. 26 U.S.C.A. (I.R.C.1954) §§ 274(a)(1)(B), 274(a)(2)(A).

6. Internal Revenue – 555

Portion of club dues corresponding to cost of taxpayer's own meals were "directly related" to active conduct of taxpayer's business and deductible where club dues represented cost of taxpayer's access and access of his business guests to entertainment facility. 26 U.S.C.A. (I.R.C.1954) §§ 274(a)(1)(B), 274(a)(2)(A).

Arthur A. Russ, Jr., Buffalo, N. Y. (Albrecht, Maguire, Heffern & Gregg, Buffalo, N. Y., on the brief), for appellants.

Robert D. Bickel, Dept. of Justice, Washington, D. C. (Johnnie M. Walters, Asst. Atty. Gen., Lee A. Jackson, Grant W. Wiprud, Dept. of Justice, Washington, D. C., on the brief), for appellee.

Before LUMBARD, Chief Judge, and ANDERSON and FEINBERG, Circuit Judges.

ANDERSON, Circuit Judge:

The issues presented by this appeal from a determination of a deficiency by the Tax Court[1] are whether the taxpayer, Harry G. LaForge, failed adequately to substantiate certain entertainment deductions and whether the Tax Court correctly computed the portion of his country club dues which were deductible as an entertainment facility expense.

The taxpayer, a surgeon at Buffalo General Hospital, regularly paid for the lunches of the residents and interns who assisted him. The cafeteria cashier was forbidden by hospital rules to issue receipts for these expenditures, but she testified before the Tax Court that Dr. LaForge regularly purchased his lunch and the lunches of his assistants at a cost of $2.65 to $3.00 each day. The taxpayer kept no contemporaneous account of these expenditures, nor did he file with his return a written statement itemizing the cost of the lunches. Instead, on his 1964 and 1965 income tax returns, he deducted $2.00 for each day of his hospital schedule. Though conceding that the taxpayer's luncheon expenditures met each of the substantive requirements of §§ 162 and 274 of the Internal Revenue Code of 1954, the Commissioner contended that the taxpayer's testimony, and that of the cafeteria cashier, did not fulfill the substantiation requirements of Treas. Regs. § 1.274-5(c)(3) and that the deduction must for that reason be disallowed. On this basis the Tax Court determined a portion of the challenged deficiencies.

The remaining portion of the deficiencies arose from the Tax Court's disallowance of taxpayer's deduction of the entire amount of his 1964 and 1965 country club dues. The Commissioner conceded that the taxpayer used the country club facilities primarily for the furtherance of his practice and that he was entitled to deduct that portion of the dues which was "directly related" to the active conduct of his practice. § 274(a)(1)(B). Treas. Regs. § 1.274-2(c)(6) provides a formula for computing the portion of club dues so "directly related." Applying this formula the Tax Court excluded from its computations the cost of the taxpayer's meals, ruling, in effect, that the portion of the dues corresponding to the cost of the taxpayer's own meals was not "directly related" to the conduct of his medical practice.

I.

To put an end to abuses which had developed through the use of expense accounts, Congress in 1962 amended the Code to provide rules for the substantiation of entertainment expense deductions. Section 274(d) provides that an otherwise deductible entertainment expense shall not be allowed "unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement" the amount, time, place and business purpose of each such expense and the taxpayer's business relationship to the persons entertained. To substantiate such expenditures by "adequate records," the regulations require taxpayers to maintain an account book or diary in which each element of an expenditure is contemporaneously recorded and to supplement account entries with such documentary evidence as itemized receipts. Treas. Regs. § 1.274-5(c)(2). If a taxpayer does not compile "adequate records," he must establish each element of the expenditure by his own written statement and by other corroborating evidence. Treas.Regs. § 1.274-5(c)(3).

[1] Conceding that he neither compiled "adequate records" nor filed with his return a written statement substantiating the claimed deduction for luncheon expenditures, the taxpayer contends the regulation's demand for a written statement goes beyond the statutory requirement of substantiation by "sufficient evidence corroborating his own statement." We agree. To require a written statement itemizing each expenditure is, in effect, to compel the taxpayer to maintain "adequate records" and thereby to dismiss from the statute one element of its disjunctive substantiation requirements. Moreover, the draftsmen of § 274(d) contemplated substantiation by oral testimony:

> "[T]he degree of corroboration required to support a claimed deduction will vary as respects the business relationship and purpose, the time and place, and the amount of the expense. Thus, oral testimony of the taxpayer together with circumstantial evidence available, may be considered 'sufficient evidence' for the purpose of establishing the business purpose required under the new provision. However, oral testimony of the taxpayer plus more specific evidence would be required to be 'sufficient evidence' as to the amount of an expense."

S. Rep.No. 1881, 87th Cong., 2d Sess. (1962) in 1962-2. U.S.Code & Cong. Admins. News, pp. 3337-38.

[2-4] Though oral testimony properly corroborated may fulfill one of the statute's alternative substantiation requirements, the taxpayer's testimony here was not sufficiently precise to substantiate the claimed deduction. Taxpayer testified to the amount, regularity and purpose of his luncheon expenditures over a two-year period. Absent evidence concerning the cost of taxpayer's own lunches, which were not deductible,[2] taxpayer's testimony was too much the approximation condoned by Cohan v. Commissioner of Internal Revenue, 39 F. 2d 540 (2d Cir. 1930). In light of the position we have taken today, taxpayer should be afforded an opportunity to prove the cost of his own meals as part of his testimonial substantiation.[3] At

[1] The findings of fact and opinion of law of the Tax Court are reported at 53 T.C. 41 (1969).

[2] Unless the taxpayer demonstrates that the cost of a business meal exceeded that amount which he would have been required to spend in any event for his sustenance, no deduction will be allowed. Richard A. Sutter, 21 T.C. 170 (1953); see James v. United States, 308 F. 2d 204 (9 Cir. 1962). Taxpayer here made no such showing.

[3] The unlawful approximation condemned here is not the fact that taxpayer could not state the precise amount of each luncheon expenditure, for to require him to do so would in effect require him to make some contemporaneous written notation; and any such notation would be enough to qualify under Reg. 1.274-5 (c)(3), which we are today invaliditing. Rather the unlawful approximation is the fact that taxpayer did not demonstrate the cost of his own lunches. Hence if taxpayer can show on remand the maximum cost of his own lunches, a deduction for the remaining amount should be allowed.

that time the taxpayer will also have an opportunity to press his claim that the Internal Revenue Service applies the *Sutter* rule, see footnote 2, *supra*, only to cases of abuse, Rev. Rules 63-144, 1963-2 Cum. Bull. 129, Q & A 31, and that his case does not fall into that category.

II.

A taxpayer's expenditures for an entertainment facility are deductible only if the taxpayer establishes that (a) the facility was used "primarily for the furtherance of the taxpayer's trade or business" and (b) the expenditures were "directly related" to the active conduct of the taxpayer's trade or business. § 274 (a)(1)(B). Club dues are considered by the statute to be facility expenditures. § 274 (a)(2)(A). Because the Commissioner concedes that the taxpayer used his country club primarily for the furtherance of his professional practice, the only question here is what portion of his club dues were "directly related" to that practice.

[5] Treas. Regs. § 1.274-2 (c)(6) quantifies this "directly related" concept by permitting, as a facility expense deduction, that portion of the dues which corresponds to the taxpayer's actual use of the facility for business entertaining. A taxpayer may deduct that fraction of the total dues that corresponds to the percentage, which the taxpayer's expenditures for business meals taken at the club represent, of his total yearly expenditure for food and beverages purchased at the club.

[6] The portion of dues corresponding to the cost of the taxpayer's own meals, which the Tax Court ruled nondeductible, are by this test "directly related" to the active conduct of his practice. The club dues represent the cost of the taxpayer's access, and the access of his business guests, to an entertainment facility. Because the taxpayer's presence was a prerequisite to the Tax Court's finding that his country club entertaining was in fact business entertaining, the cost of taxpayer's access was "directly related" to his practice within the meaning of § 274 (a)(1)(B).

The case is remanded to the Tax Court to permit the taxpayer an opportunity to prove the cost of his own hospital cafeteria meals and the cost of his club meals and for further proceedings consistent with this decision.